Subcommittee on Securities, Insurance and Investment
"Subprime Mortgage Market Turmoil: Examining the Role of Securitization"
Senator Jack Reed
April 17, 2007

Our hearing this afternoon builds on the record begun last fall by Senators Allard and Bunning when the Subcommittee on Housing and Transportation, and Subcommittee on Economic Policy, first started to look at these issues.

We have had a dramatic increase in home loan delinquencies and foreclosures, the closure or sale of over 40 subprime lenders, and an increase in "buybacks" of delinquent loans in recent months. While the subprime market has experienced most of the turbulence, there are now signs of weakness in the Alt-A market.

This is a complicated issue. Chairman Dodd and Senator Shelby have held a number of hearings where we've heard from brokers, originators, regulators, and borrowers regarding the causes and consequences of the current mortgage market turmoil. However, we are here today to look at the financial engine which helps drive this market-- the securitization process.

Clearly, there are many benefits from securitization. Securitization creates liquidity, enables lenders to originate a greater volume of loans by drawing on a wide source of available capital, spreads risk, and allows investors to select their risk level or pattern of returns. When securitization works well, it bridges the gap between borrowers and investors and makes homeownership more affordable.

However, what happens when it does not work as well as it should? For example, it is possible that securitization can create perverse incentives, such as an erosion of underwriting standards or the development of exotic loan products that do more harm than good?

Lewis Ranieri, the pioneer of mortgage-backed securities recently stated that he believes "standards are largely set by the risk appetites of thousands of hedge funds, pension fund and other money managers around the world. Emboldened by good return on mortgage investments, they have encouraged lenders to experiment with a profusion of loans."

As many credit-stressed borrowers still face resets on some of these exotic loan products, The Center for Responsible Lending has estimated that one in five subprime loans originated during the prior two years will end in foreclosure, costing homeowners $164 billion, mostly in lost equity.

Lastly, there is some cause for concern on the investor front. Lewis Ranieri stated last year: "When you start divorcing the creator of the risk from the ultimate holder of the risk, it becomes an issue of, 'Does the ultimate holder truly understand the nature of the risk that you've redistributed? By cutting it up in so many ways or complicating it by so many levels, do you still have clarity…on the nature of the underlying risk? It is not clear that we haven't gone, in some ways, too far—that we have not gone beyond the ability to have true transparency. That is a fair question many of us in the business and people in the regulatory regime are wrestling with."

A related issue on this front is the steadily increased loss expectations for pools of subprime loans. According to a recent Moody's report, "loss expectations have risen by about 30% over the last three years." Loss expectations ranged "from an average of 4% to 4.5% in 2003 to an average of 5.5% to 6% today." I am particularly concerned about possible downgrades of these securities that could affect pension plans and other large institutional investors.

Therefore, the purpose of our hearing this afternoon is twofold. First, we want to examine how subprime mortgages are securitized, how credit risk for mortgage-backed securities is determined and monitored, and what effect the recent increase in defaults and foreclosures has had on the subprime securitization market.

Second, we want to learn what role, if any, the securitization process has played in the current subprime mortgage market turmoil, and what issues Wall Street and Congress should consider as we move forward.